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COLO B.CO - Q2 2017 Coloplast A/S Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the H1 2016/2017 earnings release conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Lars Rasmussen, CEO. Please go ahead, sir.

Lars Rasmussen - Coloplast A/S - CEO and President

Thank you. Good afternoon, and welcome to our Q2 '16/'17 conference call. My name is Lars Rasmussen, I'm CEO of Coloplast. And I'm joined by CFO, Anders Lonning-Skovgaard; and our Investor Relations team. We'll start with a short presentation by Anders and myself, and then we'll open up for questions.

Please turn to Slide #3. Today, Coloplast delivered 7% organic growth for Q2. And I'm very pleased to see continued strong performance in Europe, across our business areas and double-digit growth in the U.S. Chronic Care business as well as improved momentum in the Chinese Wound Care business.

The growth in Wound & Skin Care in Q2 was below our expectations. Due to timing effects, the U.S. Skin Care business was negatively impacted by DKK 30 million in the first half of the year. The growth in U.S. Skin Care is expected to rebound in the second half of the year. The Wound Care business in general was negatively impacted by price reforms in France and challenging dynamics in emerging markets.

On a positive note, we continued to have a firm grip on our costs, and we delivered a 33% EBIT margin in fixed currencies for the first half of the year -- first half of the fiscal year.



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Today, the Board of Directors approved an interim dividend of DKK 4.5 per share corresponding to a total interim dividend payout of almost DKK 1 billion. Our organic revenue guidance for '16/'17 is unchanged at a growth of 7% to 8%. Our guidance in Danish krone is also unchanged at 7% to 8%. Our EBIT margin guidance is unchanged in fixed currencies at 33% to 34%, and in Danish krone around 33%.

Please turn to Slide #4. Before we take a further look at the numbers, I would like to take this opportunity to give a brief update on our LEAD20 strategy. Innovation continues to be the cornerstone of our company. I'm very pleased to currently have a strong range of new products in the market across all of our business areas.

SenSura Mio Convex is currently being relaunched, now that we have expanded our production capacity to meet the strong demand in the markets. SpeediCath Flex, Biatain Sizes & Shapes and our most recent SensSura's launch Brava Protective Seal have now been launched across all mature markets. Within Ostomy Care we continued to strengthen our SenSura Mio product offering, with the launch of our new Hospital Assortment in this quarter. We have increased our activity level within innovation. And this is reflected in our R&D-to-sales ratio, which is currently focusing year-to-date. Our Coloplast Care enrollments are growing according to plan and are around 15% to 20% per year. We have now in excess of 0.5 million users in Coloplast Care and in excess of 1 million users in our database. Coloplast Care is fully rolled out in more than 20 countries. And we are continuously upgrading the offering to add value in each market, bearing in mind that market requirements are very different from market to market. The integration of the acquisition of Comfort Medical is developing according to plan. And I'm excited about the vast opportunities that we have tapped into within Continence Care in the U.S.

Finally, we are on track with our innovative -- innovation excellence efforts, SpeediCath Flex, Brava Protective Seal and the new SenSura Mio Hospital Assortment are examples of products launched, where production has been ramped up directly in Hungary and China. We have also reduced the number of production employees in Denmark by 100 in the first half of the year.

Please turn to Slide #5. Year-to-date, our revenues grew 6% organically and 5% in the Danish krone and amounted to DKK 7.6 billion. The acquisition of Comfort Medical contributed DKK 67 billion or approximately 1% to RevPAR growth in Danish krone. In Ostomy Care, organic growth was 7% and growth in Danish krone was 5%. For Q2 in isolation organic growth was 7%. Growth continues to be driven by our SenSura and Brava accessories portfolio in larger markets like U.K., Germany, U.S. and China. In particular, SenSura Mio Convex continues to contribute to growth. And as mentioned above, the production capacity on Convex was increased significantly at the end of March. Growth in Q1 was negatively impacted by the anticipated inventory reductions at our largest distributors in the U.S. The inventory level is now fully normalized. And in Q2, we saw double-digit organic growth in the U.S. Our Assura and Alterna portfolio growth was driven by satisfactory performance in China, Russia and Argentina.

In Continence Care, organic growth was 6% and growth in Danish krone was 5%. For Q2 in isolation organic growth was 8%. The SpeediCath ready-to-use intermittent catheters continues to drive growth and especially, the compact versions performed well. In the Compact segment, we saw strong growth in the U.S. as well as satisfactory growth in the U.K. and France.

Growth in Q1 was negatively impacted by inventory reductions at our largest distributors in the U.S. The inventory level is now fully normalized. And in Q2, we saw double-digit organic growth in the U.S., driven by strong demand for hydrophilic catheters. Our Conveen collecting device portfolio posted slightly positive growth due to satisfactory growth in France and China.

Finally, sales growth for our Peristeen products remain satisfactory, especially in the U.K., U.S. and France. SpeediCath Flex has now been launched in 13 markets, and the feedback continues to be very positive, which is reflected in the sales performance in Q2.

In Urology Care, organic growth was 11%, and growth in Danish krone was 12%. For Q2 in isolation organic growth was 14%. The growth was primarily driven by sales of female pelvic health products, a segment in which we have gained market share after a large competitor exited the market approximately 1 year ago. Our market share in female pelvic health in the U.S. has increased from an estimated 10% to 15% to 15% to 20%.

We also continue to see satisfactory growth in the sales of the Titan range of inflatable penile implant devices. And finally, our endourology business saw satisfactory growth in Europe, in particular, in France.



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In Wound & Skin Care, organic growth was -- and growth in Danish krone was 0%. Organic growth for Wound Care in isolation was 5%. For Q2, organic growth for the total business area was negative 4%, and for Wound Care in isolation it was 2%. The growth continues to be driven by Biatain sales, in particular, Biatain Silicone in Europe and Biatain Super, increase. As mentioned earlier, the Skin Care business was challenged by a high baseline last year. In Wound Care, the growth was challenged by price reforms in France and weaker momentum in a number of emerging markets, including Brazil and Greece. In Greece, performance in Q1 was lifted by stock building due to a shift to a new product portfolio as a result of the health care reforms. The inventory was partially reducing Q2, but the inventory reductions were continued throughout the year. In Q2, as mentioned earlier, China contribution to growth after a number of challenging quarters. Finally, contract manufacturing of Compeed impacted growth negatively.

Turning to our geographical segments. We saw organic growth of 6% year-to-date and 5% in Q2 in our European markets. The growth continues to be satisfactory across the portfolio of countries and, in particular, in the U.K. where Charter continues to take market share. The period also saw satisfactory growth in France and Southern Europe. Organic revenue growth in other developed markets was 6% year-to-date and 8% in Q2. As mentioned earlier, the improvements in Q2 reflects the fact that the inventory levels at our largest distributors are now normalized. And we saw -- and we are seeing double-digit organic growth in our U.S. Chronic Care business, which now reflects the actual market demand. Our growth rates in Canada, Japan and Australia all remained satisfactory. Revenue in emerging markets grew organically by 8% year-to-date and 10% in Q2. The growth was primarily driven by China, Argentina and Russia. China contributed to growth due to satisfactory growth within Ostomy Care. And as mentioned earlier, the growth momentum in China within the Wound Care business has improved compared to last year, but it is not yet satisfactory. Finally, a lower tender value in Saudi Arabia had a significant impact on Q1, and Brazil continues to be negatively impacted by funding challenges.

With this, I'll now give the word to Anders. Please turn to Slide #6.

Anders Lonning-Skovgaard - *Coloplast A/S - CFO and EVP*

Thank you, Lars, and good afternoon, everyone. Gross profit was up by 5% to around DKK 5.2 billion. This equals a gross margin of 68%, which is on par with last year. We continued to see improvements in our production efficiency at our volume sites and, in particular, a positive impact from the relocation of SenSura Mio and Compeed to Hungary, which compensates for the negative gross profit impact from the launch of new products where the production economy is not yet fully optimized. The gross profit was also impacted by a 15% increase in the minimum wage level in Hungary, increasing depreciation levels and cost associated with the relocation of production to Hungary. Q2 was also impacted by DKK 13 million in restructuring costs related to the reduction in the number of production employees in Denmark. The distribution-to-sales ratio came in at 28% compared to 29% last year. The ratio was impacted by sales and marketing investments in the U.S. and within Wound Care. The admin-to-sales ratio came in at 4% of sales, on par with the recent trend. Q1 was impacted by DKK 7 million in transaction costs related to the acquisition of Comfort Medical. The R&D-to-sales ratio came in at 4% of sales compared with 3% for the same period last year. The 17% increase in R&D cost reflects a higher general activity level. Overall, this resulted in an increase in operating profit in fixed currencies of 8% and 5% in actual currencies, corresponding to an EBIT margin of 33% in fixed currencies and 32% in actual currencies. Operating cash flow amounted to DKK 558 million compared with DKK 1,94,000,000 last year. The positive impact from higher absolute earnings was offset by payments on escrow accounts to settle mesh claims. Year-to-date, mesh payments totaled DKK 1.5 billion, and total mesh payments to date now amount to DKK 3.9 billion.

Cash flow from investing activities was impacted by the acquisition of Comfort Medical for approximately DKK 1.1 billion, and capacity expansion in machines for the production of existing and new products and the site expansion in Tatabanya in Hungary. Investments in intangible assets and property, plant and equipment amounted to DKK 262 million year-to-date. The sale of bonds provided DKK 155 million cash contribution. Adjusted for payments made in connection with the mesh litigation and the acquisition of Comfort Medical, the free cash flow amounted to approximately DKK 1.3 billion compared to DKK 1.8 billion last year. The differences is explained by lower tax payments last year, which means that the underlying cash flow is in line with last year.

With respect to the mesh litigation, Judge Goodwin stated last week that the MDL for Coloplast is in its final phase. We have settled more than 95% of the known cases against Coloplast. And at the end of this financial year, we expect to have paid out DKK 5 billion of the total provision of DKK 5.25 billion.



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Finally, the second half of the approved share buyback program of, in total, DKK 1 billion was initiated in the second quarter. And at the end of the quarter, shares worth of DKK 137 million had been bought back.

Please turn to Slide #7. Our organic revenue guidance for '16/'17 is unchanged at an organic growth of 7% to 8%. Our reported growth in Danish kroner is also unchanged and expected at 7% to 8%. The acquisition of Comfort Medical is expected to contribute 1.5 percentage points to the reported growth. Our guidance assumes stable growth rates in Europe and higher growth rates in North America in the second half of the year. We also assume that emerging markets growth will be in the range of 10% to 15%, which reflects an improved growth trajectory of China Wound Care. We also assume an improved outlook for Skin Care and contract manufacturing in the second half of the year.

Finally, our guidance assume a positive impact for the remainder of the year from the relaunch of SenSura Mio Convex and the recent product launches, including SpeediCath Flex and Brava Protective Seal. We expect a negative price -- pricing pressure of around 1 percentage point on our top line. And this is reflected in our guidance.

Year-to-date, we have seen a moderate pressure from pricing reforms within Wound Care in France and Greece. For '16/'17, we continued to expect an EBIT margin of 33% to 34% in fixed currencies and around 33% in Danish kroner. Higher growth from our new product launches still means pressure on the gross margin, but we continued to relocate manufacturing out of Denmark to Hungary and have reduced the number of production employees in Denmark by 100 in the first half of the year.

We expect the benefits to be absorbed by the cost of relocation and restructuring cost in 2016/'17. We also expect depreciations to increase at the same level as last year, as a consequence of the last couple of years increasing CapEx. We continued to expect our net financials to end the financial year '16/'17 at around minus DKK 100 million, impacted primarily by cash flow hedged losses on the U.S. dollar, Brazilian real and Argentinian peso offset by hedging gains on the British pound.

CapEx guidance for '16/'17 is expected to be around DKK 700 million, and is driven particularly by investments in more capacity and for new and existing products, including SenSura Mio, Biatain Silicone and SpeediCath Flex, as well as the Nyírbátor expansion, which is expected to be operational during the first half of 2017/'18. Finally, our effective tax rate is expected to be around 23%.

This concludes our presentation. Thank you very much. Operator, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will take our first question today from Chris Cooper from Jefferies.

Chris Cooper - Jefferies LLC, Research Division - Equity Analyst

I've got 3, please. Firstly, it is on manufacturing for ostomy. Can you just confirm exactly when the additional capacity of business to your EMEA came on stream. I think some of us had been expecting a little bit more of a step-up just due the pent-up demand. I just want to make sure this total spend organic had met your expectation. And also just how you expect that to trend through the rest of the second half? In the U.K., Charter things were taking share, again, I know historically it's not always been easy to sustain some of the share gains in that market. Can you just talk us through some of the drivers there, and how you've achieved that progress? And then lastly, I just wanted to know your latest expectations were about the competitive bidding program in the U.S., please. And then previously, the focus has been more on Ostomy and Urology, but I just wanted to grab your thoughts on whether you see any risk that Catheters are placed on this list, too. And also just whether the incoming administration makes the outcome more or less likely, in your opinion?



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Lars Rasmussen - Coloplast A/S - CEO and President

Thank you very much. For the manufacturing -- for the Convex, as you said, it came online end of March and that is end of March. It's not like probably, 15th of March and in the end of the month. It is the end of March, so meaning that it's fully present at the present April. So that's in line with what we have communicated. So there is no effect from extra capacity in the quarter that we are just reporting. It is fully present from the beginning of this quarter. And for the U.K., so could you give me a little bit more flavor on your question for what it is that we're doing, you want to understand what exactly we're doing to pick up more growth in the U.K.?

Chris Cooper - Jefferies LLC, Research Division - Equity Analyst

Yes. I mean, you commented during the prepared remarks that this is another quarter where you taking share with Charter, and I think that reflects in the growth numbers. I just know historically, it's not been a, let's call it, an easy market, the Spain share gains are better over a period. I just want to know what was happening in the market, and why you were having such success in more recent months in taking share?

Lars Rasmussen - Coloplast A/S - CEO and President

It is -- it's in the sense -- it's a classic explanation. So it is a combination of products that we're offering. So we have new products across the board for the time being and in the service offering. So we are selling Charter Healthcare with specific promises on what to expect when you are a patient in terms of response rate and delivery performance, and so on so forth. And also a specific sort of KPIs that we're selling in really comes to a service level you can expect. When you are a professional person, so meaning a nurse calling into a Charter Healthcare to sign off the patient or to get -- or to ask questions or other things like that. So in that sense, it's quite specific what we're offering. And we also used the channel, of course, to cross-sell, meaning that we are selling our Brava accessory products also in that segment. On the competitive bidding side, the Trump administration have not pursued that it was part of the list that Obama -- the Obama government was pushing for, but Trump have not pursued that, and that seems we actually consider it to be very far down on our risk list for the time being. Also for catheters in the U.S., which is what you are asking for specifically.

Chris Cooper - Jefferies LLC, Research Division - Equity Analyst

Got it. And perhaps, just have 2 quick follow-ups. Just on the last one. I understood that the product had sort of remained on the provision, I know -- and the Trump administration publicly showing no intention at this stage progressing, but the fact is they're still back on that list. Can you just confirm my understanding there. And just a quick follow-up on the first one.

Lars Rasmussen - Coloplast A/S - CEO and President

So it's not -- to our understanding it's not on the list.

Chris Cooper - Jefferies LLC, Research Division - Equity Analyst

It's no longer on the list. Okay. And just on the first one. Now the capacity is fully on stream. I mean, in your eyes is there any reason why we shouldn't expect double-digit, if not 13% in terms of Ostomy performance for the second half?

Lars Rasmussen - Coloplast A/S - CEO and President

I'm not sure that I'm prepared to give you a guidance for Ostomy growth in the second half. But of course, it's a fact that we have holdback on pushing this product in our direct-to-consumer channel. And we have not even launched the product in all places in the hospital channel. So, of course, with such a long-time where we have been out -- without sufficient capacity, we actually -- are not just bringing more new products online,



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we do a real relaunch of the whole portfolio to the market. So we do expect -- we certainly, do expect added growth from this. But I can't go as far to guide you on of Ostomy growth in the second half.

Operator

Our next question today comes from Romain Zana from Exane BNP Paribas.

Romain Zana - Exane BNP Paribas, Research Division - Research Analyst

The first one would be on the margin side. It seems that the efficiency gains have been more or less partly offset by the wage inflation you mentioned in Hungary. So I was wondering to what extent the inflation achieved to all or something temporarily, and how do you intend to balance it? The second question is regarding the increased revenue activity you mentioned. Is it related to a specific business segment and should we extrapolate these trends, I mean, the sales ratio looking forward? Or it's more or less cyclical?

Lars Rasmussen - Coloplast A/S - CEO and President

So in terms of the question related to our gross margin, we are seeing some tailwind from the fact that we are moving out machines from Denmark to Hungary. We have last year and also this year been moving out a number of machines that we have established in Hungary. And as part of our innovation excellence program, we have also established the production of some of our new products directly in Hungary. So that is having a positive impact. On the negative side, we have in this quarter -- the second quarter included restructuring cost of DKK 13 million related to reduction of employees in Denmark. But I also expect that we will see a positive impact from that rest of the year. On top of that, as you're also mentioning, and we're seeing higher salary increase in Hungary, and we're also seeing higher depreciation levels due to the fact that we have a higher CapEx level than we have had previously. So for the first half, it is more or less balancing the efficiency gains out with some of the extra costs that we have had.

Romain Zana - Exane BNP Paribas, Research Division - Research Analyst

The inflation was something you were expecting or...

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

The inflation rate that we're seeing this year of around 15% is something that was announced earlier this year. And it is a bit higher than we originally expected.

Lars Rasmussen - Coloplast A/S - CEO and President

So if I can just add to what Anders said, and then I also mentioned it during my opening remarks that we actually have more products now that we have ramped up directly in low cost countries. And that's part of this innovation excellence model that we are implementing. And that means that, for example, a product by SpeediCath Flex is started directly in Hungary where we have no -- basically, no sort of running curve where we have higher cost, but we stop more or less on cost wise. It's a big undertaking for us and it seems as if we are succeeding with it. So we are actually very, very happy with that. And that is also going forward things that are helping us to improve on our gross margin. When it comes to the increased R&D cost, I have said many times that we're willing to take on the R&D which is necessary to drive to the top line growth. So if we really see good projects, we'll also support them. We have just launched across the board new products. And we have a very compelling pipeline of new products to come. So that's why we spent more money on that part and the products that come are also pretty well documented like, for example, the Convex product that came out now with a clinical documentation that does reduce leakage. So that costs a little bit more, but it's also having



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significant impact in the market. So that's a -- that's right. So if you look at the product portfolio, we have -- it is across the board. It's not just in Ostomy Care or just in Continence Care. It is across the board.

Romain Zana - *Exane BNP Paribas, Research Division - Research Analyst*

So would you rule out that inflation of this ratio looking forward?

Lars Rasmussen - *Coloplast A/S - CEO and President*

Can you say that again, please?

Romain Zana - *Exane BNP Paribas, Research Division - Research Analyst*

I mean, do you rule out that the sales ratio on R&D could decrease overall?

Lars Rasmussen - *Coloplast A/S - CEO and President*

We -- what we're guiding to the market and have done for quite some years is that we expect the R&D ratio to be around 3% to 4% of sales. We have so much now in the pipeline that we are at the top end of this, and I consider it to be very positive because that is -- that's a key element in driving high top line growth also going forward.

Romain Zana - *Exane BNP Paribas, Research Division - Research Analyst*

And just the last question, very basic, regarding the Wound Care in each group, the catch-up we are expecting, I mean, how confident are you with this catch-up? What kind of visibility do you have at this stage?

Lars Rasmussen - *Coloplast A/S - CEO and President*

Yes. I think that if you look at Europe, per se, it's very positive, it's only France that is standing out on a negative -- or in a negative way. So in France, there was a slight decrease of prices, but they also decreased the number of products in the boxes from 16 to 10. So that means that when you have an ordering cycle where people normally, they just order boxes. Then they will figure out that they need to order more frequently, but when that kicks in, you get a negative impact, so we have had that. So I expect that France will be better in the second half. Then we have seen that Wound Care is picking up quite well. And we expect that to continue into the second half, so that will help us in that respect. So those are 2 of the big levers that will take it back. And then we also said that we had a little bit weaker sales in the U.K., but if you -- that actually public in market sales days in the U.K. And there you can see that all companies are actually in the quarter we're just recording having a negative impact. And we have probably the least of the negative impact. So we just expect that to be pickup, again, going into the second half of the year. So we feel quite confident that we will have a pickup and then to top it up, of course, we have this very big negative one on skin care in the U.S. where we -- this is now out of the books.

Operator

Our next question comes from Veronika Dubajova from Goldman Sachs.



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Veronika Dubajova - Goldman Sachs Group Inc., Research Division - Equity Analyst

I have 3, please. The first one is just looking to the balance of the year. Obviously, the organic revenue growth year-to-date is at 6%, the guidance is at 7% to 8%. Lars, can you maybe talk about would you feel comfortable right now at the lower or the upper end of that organic revenue versus guidance. And what do you see as the biggest levers for the second half of the year? It just would be helpful for us to get an overview on that. My second question is a follow-up on gross margin dynamic for Anders. And I think, Anders, last time when we caught up, your suggestion was you would expect to see some modest gross margin improvement this year. With the wage inflation now being a headwind, should we instead assume that gross margins are flat? And any risk as you think about beyond the fiscal -- beyond this fiscal year that your wage inflation remains a significant problem in Hungary? And then my last question is just on the Slovakia announcement and your thoughts behind on the plot that you bought in Slovakia for a new plant, just kind of your thoughts on -- you're adding in another country into the network, are you -- what's behind that? And how soon will you start investing into that plot?

Lars Rasmussen - Coloplast A/S - CEO and President

Yes, all right. If you take the balance of the sales, well, I think that if you take or my take on this is that in the first half we had to reduce the stocks in the U.S. and that to an amount of USD 10 million. And then we had the one-off on skin care, which is not going back. So those 2 alone is DKK 100 million, which was hit in the first half and they will not come back. And then going into the second half of the year, then we have the relaunch of Convex. It's actually a quite big launch that we're doing there. And we saw the pickup on the first part of it, so we expect to get an impact from that. We have Flex, which had been received really well in the market. Even though it's early days, we are above the launch forecast for that. And then we have the Brava rings that actually are very -- it's very competitive products that we have brought to the market. And it's coming into the biggest single category, which exists in the accessory markets. So and where we have -- I think, you could call it a low market share. So in that sense, we only have 15% market share in there. So we think that we can take a significant part of the market there with the offering that we come with. And just to give it -- give you some flavor on this rings alone is between 30% and 40% of the total accessory market. So it's quite important. So those factors -- are the most important factors that we're looking at. But then, of course, to top it off, we have a positive growth now in the U.S., and double-digit growth. And we see that the Wound Care growth in China is coming back. So I'm actually -- I think, it's very well funded when we talk about for the development in the second half. And when it comes to, let me take Slovakia now that I'm speaking. Then we have -- I think we are quite big in Hungary. We are growing as a company, so we need more manufacturing space. And we're not yet ready to open up more manufacturing outside of Europe. The next place that we talked about, that also will probably be somewhere in North America, but that's not by now. So we have chosen to go to Slovakia to spread the risk a little bit, and that is in a region which is pretty close to Hungary. So we have some similarities of the language, and we think we can cover a lot of what needs to be done in the initial phase from our setup at having Hungary at this point in time because of the geographical distance. So that's the reason why is it Slovakia, we will see something up and running there within the next couple of days.

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

Yes, and Veronica, in terms of the gross margin question. So overall, as you know, we have launched our innovation excellence program where we are planning to reduce a number of FTEs, production FTEs in Denmark was around 300 people by the end of next year. So -- and so far, since we introduced the program, we have reduced with around 200 FTEs. So overall, we're on track with this program. And I expect also that this program will contribute to the gross margin development in the second half of this year. Also because that I have -- we have included the majority of the restructuring cost related to the innovation excellence program in the second quarter, so we have some one-offs included in our second quarter that will not come in the second half of the year. So my expectation is that the gross margin will also contribute for us to deliver on the EBIT margin guidance of 33% to 34%.

Veronika Dubajova - Goldman Sachs Group Inc., Research Division - Equity Analyst

Okay, that's very clear. And, Lars, if I can just follow-up on -- we've asked a lot about Ostomy, but I think Continence, if you look, sequentially didn't seem to accelerate much even though you had no destocking in the second quarter? Anything there that worries you or that might explain why the growth wasn't better in the second quarter?



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Lars Rasmussen - *Coloplast A/S - CEO and President*

No, I think, if you look at the organic growth of Continence Care, I think that's -- that is showing some acceleration, we had 8% growth in Q2 and 6% for the first half. So I'm actually quite pleased with that.

Operator

Our next question comes from Michael Jungling from Morgan Stanley.

Alexander Matthew Gibson - *Morgan Stanley, Research Division - Research Associate*

It's Alex Gibson instead. I have 2 questions. The first one is on gross margin and the outlook more longer term. So in the past that -- things as the expansion in EBIT margin has been driven in large part by improvement in gross margin. But if you look at the last few quarters and years there hasn't been much year-over-year improvement. What confidence do you have on maybe guidance on what split -- the margin improvement for the mid-term is going to be down to gross margin and for operation? And then my second question is on China. And I believe there's a meaningful sales force reduction or maybe just stabilization in the sales force in China. Can you comment on how much your increasing sales force expansion in that market is now?

Anders Lonning-Skovgaard - *Coloplast A/S - CFO and EVP*

Yes. So if I just talk to the gross margin. So as you know, our overall financial guidance is improving in our EBIT margin of 50 to 100 basis points in fixed currency scenario. And our expectation is that the gross margin will also contribute, overall, in order for us to deliver on that financial ambition. We have seen a gross margin in the last 2 to 3 years that has been more or less to flat. And the reasons -- there are a couple of reasons for that. One reason is that many of the new products we've been launching over the last couple of years that they have been produced in Denmark. And that's also why we have initiated this Innovation Excellence Program, where we are moving production of those new products to Hungary. And so that's one element. The other element, we have also been impacted a bit from the currency on our gross margin especially from the Sterling that has dropped quite a bit last year after Brexit. But we believe that with the Innovation Excellence Program and the initiatives we're working on moving production of our new products that, that will improve the gross margin over time when we are finished with the Innovation Excellence Program. And we still expect that, that will be finalized by the end of '17/'18. And we are expecting savings at that point in time of DKK 80 million to DKK 100 million. So overall, we are expecting that the gross margin development will contribute to our overall EBIT margin expansion. So that's how we see it.

Lars Rasmussen - *Coloplast A/S - CEO and President*

I mean, it -- when it comes to China and the sales force in China, it's correct that we have quite a sizable sales force in China. For some years, we were expanding every year also in a significant way, also in spite of Wound Care. But when we came into this change in the way that products are registered in the single hospitals. And you are in China, a couple of years back, we stopped scaling our setup in China simply to change the model that we're working with. So the model that we're working with currently is that we have to show that we are having a recurrent sale in the hospitals that we already are in, and that we're growing our business with the customers like that were already having it. That is what is starting to show a bit now. As we see that, that is being more and more successful, we'll start scaling again. So of course, we would love to invest more, but we love to invest in a profitable way. And that was the problem that we ran into when we could not scale in a profitable way. So that's what we are expecting to see out of the slight change -- slightly that we have had in China.

Operator

Our next question comes from Sebastian Walker from UBS.



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Sebastian Walker - UBS Investment Bank, Research Division - Associate Analyst

Just a couple. One on the Wound Care division. So at the Capital Markets Day you talked about the ambition of doubling the size of that business. I mean, just thinking of where do you stand on that? What levers do you need to pull, is it sort of geographies or product launches that will drive that? And then the second question is more a top-level. So I think about suppose your EBIT margin guidance, and then the 50 to 100 basis points of ongoing improvement. I suppose for '16 and '17, we are at the bottom end of the sales growth in organic terms. Does that mean you're more comfortable with the bottom of the EBIT margin range or what are your thoughts there?

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

On the Wound Care side, there are a couple of things that need to work fast to deliver the doubling of the business. We need to grow at a high pace in China, and we're coming back to that now. So that's, of course, a prerequisite that we see there. You need to see that emerging markets are also working in a, let's say, a reasonable way. And one of the big drivers in the emerging markets for us have, over the years, been increased. And for the time being, that is a shift increase because the value per base have been lower. We have actually invested more in Greece in order to pickup a higher share in this turmoil, which is going on. But of course, as we're switching from the former high-end portfolio of products to the now, you could say, more medium-range products. We see this transition coming in where we are basically replacing the whole stock that we haven't increased. But we actually expect that to come back. So both Greece and also China have had a dip, but we seem them come back now. And then the third element that really needs to work, when it comes to the sales organization is that we need to see the U.S. start to contribute in a meaningful way, because we had never really invested in the U.S. In the U.S., we have split the organization. So it's now a separate organization reporting into (inaudible) who is heading the intercity business unit. We have the VP in place, who is leading that. And we are building that as we're speaking. So we're actually investing in the U.S., and we are on plan when it comes to our expectations for that drive. So I think, that, that part of it is -- this is basically what we do on the sales side. When it comes to the other part of it, the new product offering, we're investing what it takes and also have the progress in the pipeline of products that we bring to the market to make sure that we have also -- and the pipeline behind us of products that we need in order to top the business that we're looking into. So we -- I think, that we're on track across the board. But we have had a setback in China and also in Greece, and we are recovering from that that. So we're a little bit behind on the plan, but still committed to deliver on the doubling of the business.

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

And in terms of your question around our EBIT margin guidance. So we have an EBIT margin guidance in the fixed currency scenario of 33% to 34% for the year. After the first half, we had an EBIT margin of 32.7%. And we believe that with the higher sales -- the higher absolute sales that we're expecting for the second half it will generate more profits. So that will also drive more margin combined with the gross margin element that I talked about earlier and the good cost control across the board, we expect that we will deliver within the 33% to 34% as we have guided.

Sebastian Walker - UBS Investment Bank, Research Division - Associate Analyst

Great, very helpful. Just one follow-up, if I may, on Wound as well, more in the near-term. On the French reimbursement cut, so can you give us some more detail there about what actually happened, was it just a price reimbursement cut, was it -- you mentioned something about the quantity of products you need to be booked and ordered. And then also how you responded to that? Or how do you expect, or what do you expect the second half of the year to improve in terms of that?

Lars Rasmussen - Coloplast A/S - CEO and President

But that's a -- that is a small reduction of prices, but it is primarily, the fact that the government had lowered the quantity of products in the boxes that have a quite significant effect once it's coming in, where they went from 16 products per box down to 10. It sounds a little bit crazy, but it does have this effect, but it has the effect because the professionals are ordering lot of boxes. They are not always ordering the number of the single products that are inside of the boxes. So therefore, you see this effect and then it sort of normalizes afterwards when you just get a faster reordering



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again. But that's what we're seeing also, that's why we expect products to come back. But we also have had a little bit of this price reductions. But anyways, this is what it is. If you look at the other markets in Europe, we see a pretty strong performance at least in Germany, for example, where we are growing at a very high speed, but also in other markets in Europe. So Europe is actually on average doing better than what we expected in our long-term effect.

Operator

Our next question comes from Niels Leth from Carnegie.

Niels Granholm-Leth - *Carnegie Investment Bank AB, Research Division - Co-head of Research of Denmark and Financial Analyst*

I have 2 questions. One question would be, would you expect any impact from the acquisition of Byram on the U.S. market that was announced yesterday? And my second question is about kind of more the long-term trend of the Ostomy Care markets, because we have seen in the past couple of years a number of new diagnostic tests coming to the market and some of these claim that they can discover colon cancer at a much earlier stage. And I'm obviously thinking about the Cologuard test, which seems to have gained enormous momentum in the past few quarters. Are you looking into these diagnostic tests and analyzing what kind of impact it will have to the long-term growth of the Ostomy Care market? And what kind of impact it's going to have on your strategic planning?

Lars Rasmussen - *Coloplast A/S - CEO and President*

Thank you. And as the Byram was acquired by Owens & Minor. So it's another -- it's one dealer buying another dealer or one distributor buying another distributor. And we are making business with both of them already. And in that sense, we think that we could talk about maybe an impact if Byram had been acquired by one of the other manufacturers. But since it is the same type of business it's been acquired into, we expect to continue to have a positive relationship with them. And we don't expect either a positive or negative effect from this acquisition. And for the long-term, it's quite rare that we're discussing this topic on these kind of calls. But it's right that you're obviously, correct that the cancer screening have been on it's rise for quite some years now. I think that the first time I was discussing cancer screening program for larger population was actually in Denmark, back in the -- at the end of 1990s. And Denmark plus a number of other countries, we have seen these screenings in effect for many years now. And that's maybe why we see that -- we continuously see that the number of temporary stomas are going. So for example, if you look at, like, colostomy, then 40% of stomas are permanent and 60% are temporary now. And for ileostomies, it's actually only 20% of the stomas that are permanent and the other 80% being temporary. Then you have the effect that 15% to 20% of all the initially temporary ostomies, they actually end up being permanent because people don't want to take the risk of having a surgery to put everything back into what it was before. And we're keeping a very close eye on this. But when we do that -- the only way we can see this is that even in a market like Denmark where we have had the cancer screening now for many years, we still see both volume and value growth. And it's very hard to figure out where -- what is it coming from, is it because people have to take it earlier so that they are now living for longer period of time with Ostomy and is there kink at the curve at some point in time. But what have happened is that the tests -- they are now more -- they are more advanced and the Cologuard that you talked about, it is also tested for human blood in the stool as well, other ones are doing. But they also have 9 DNA market that comes from a cancer or precancer. So you can detect early on. They also have more false positives, so that's the downside with this one. But it's been approved for -- it's received the FDA approval as the first one in the U.S. and is priced pretty high. It's USD 500 for a piece of test where it's USD 15 to USD 25 for Standard Care, but Medicare have decided to cover it. So you can actually get Medicare coverage for at least every 3 years with Cologuard and that's what giving them the tailwind. So it's adding to a movement that have been going on for many years. But -- and we're following as I'm saying. But you know, I also think that implicit in your question is will this have a negative impact on Coloplast or positive impact? I -- well, we can't figure it out, but we can see that our markets over the last 5 years consecutively have had more or less the same growth rates despite of this.

Niels Granholm-Leth - *Carnegie Investment Bank AB, Research Division - Co-head of Research of Denmark and Financial Analyst*

And would it make any sense at all for a company like yours to enter the testing market?



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Lars Rasmussen - *Coloplast A/S - CEO and President*

Well, it's not -- we have -- as I said, we have looked into it, but at this point in time I don't -- we have not made a decision for that.

Operator

Our next question comes from Annette Lykke from Handelsbanken.

Annette Lykke - *Handelsbanken Capital Markets AB, Research Division - Research Analyst*

My question is more on SpeediCath in Europe. As your patent is expiring here and potential competitors like ConvaTec most likely will launch in this area. Should we expect some of the antispending you have made there is going to be like a new or upgraded versions of the SpeediCath or SpeediCath Compact?

Lars Rasmussen - *Coloplast A/S - CEO and President*

We are, as you know, market leaders in a couple of business areas, globally. And whatever it takes to defend and build those positions, we do. And that means the service offerings and it means the product offerings. So of course, we make sure that our portfolio is addressing both the opportunities but also the challenges that we are seeing.

Annette Lykke - *Handelsbanken Capital Markets AB, Research Division - Research Analyst*

Okay. And then in Wound Care segment. To me, when you are talking about capturing off or calling the gap you have compared to competitors there. For me there are 2 areas, including master healing like AQUACEL from ConvaTec but also negative wounds pressure therapy, single-use devices. Are you considering any of these areas, are you still very reluctant to go into, for example, the single-use NVPT?

Lars Rasmussen - *Coloplast A/S - CEO and President*

It's tough for me to be very specific on what we are bringing to market in the -- both in the near future and also at least a little bit longer term. But I think we have stated very clearly at least for the negative pressure wound therapy that we are not having anything in the pipeline for that currently and with the plan we have to double the business in this time period, we don't think that we need the negative pressure wound therapy.

Operator

Our next question comes Christian Ryom from Nordea.

Christian Ryom - *Nordea Markets, Research Division - Assistant Analyst*

This is Christian Ryom from Nordea Markets. First on the U.S. chronic care franchise, you're saying that you're seeing double-digit growth rates in this quarter. Can you elaborate a little bit about how this -- how the underlying growth momentum has developed compared to the most recent quarters, as I believe you've also been saying that you have seen double-digit growth rates in the preceding quarters? And then, secondly for Anders, could you give us an update on what you expect in terms of financial -- net financial costs for the full year?



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Lars Rasmussen - Coloplast A/S - CEO and President

I think that the best way for me to comment on the first part of your question -- that is that yes, we have seen deducted the underlying growth. We think that we are in a stronger position today than we were just a quarter ago, plus we have capacity to really go for the Convex segment. We have -- there's a lot of users in the U.S. that are using accessories, and we have a fantastic offering with the ring product. So that is going to be or the shield product but that is a ring, which is going to -- which is now being launched in the U.S. And then, not least, we have the Flex product, which is also approved in the Coudé category, which is a very high-value category. And it is a product that is offering a significant benefit over other Coudé product that are in the market currently. So that's what we have to work with. And also -- so yes, we have had deducted the underlying growth, but I expect that to increase. To -- maybe to add to it, then we are also still winning in tubes, so as you know, we have more access to new hospitals under the teams (inaudible) we had before. So that means that over the last, or say just in this fiscal year, we have had more wins in acute than we ever had before.

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

And Christian, in terms of the net financials, my expectations for the full year with currency rates we have today is around minus DKK 100 million and year-to-date we had a minus of DKK 35 million.

Operator

Our next question comes from Oliver Metzger from Commerzbank.

Oliver Metzger - Commerzbank AG, Research Division - Analyst

First, again a follow-up on your performance on Wound Care. So just what time frame do you expect that the business should -- from a growth perspective should normalize that would also correspond your mid-term ambition theory. You have already said something, something to what is needed, but what's your expectations regarding the time? The second question is, Anders, you commented on moderate price pressure. So generally, your stamp sits around 1% price pressure and moderate pound lift stronger than just 1%. So potentially, you can just give us some comment on that, please? And finally, on the SpeediCath Flex, could you give us some indication about pricing premium to your traditional SpeediCath intermittent computers and also potentially an update how the SpeediCath Flex market share has developed in this advanced technology, I mean, for Medicare, I think, you mentioned 40% in the last call.

Lars Rasmussen - Coloplast A/S - CEO and President

Just to take it from the other end. For Flex, we have -- it's -- we have markets rates it's like the other high-end products that we are having. So it's more -- the specialty about this product is that it also works for testing and chemical use on Coudé product and the Coudé category is priced at very different levels. But in the U.S., it is priced at an attractive level and that's why it's improved or approved of. And I think that we have also given the normal price levels for those categories, but I think they are also publicly available. But you know where its -- the Coudé category is priced at approximately \$6.60 where a normal catheter is priced at \$1.80 when it's Medicare who is reimbursing. So that's a quiet big difference in that category. I don't know if that was what you're asking for.

Oliver Metzger - Commerzbank AG, Research Division - Analyst

Yes, that's a very good clarification.



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Lars Rasmussen - Coloplast A/S - CEO and President

For Wound Care, we will have a significantly better half second half than the first half year, But you -- I can't give you detailed guidance for next year for Wound Care. If that's what you are asking for.

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

And Oliver, in terms of your question related to price, so we are expecting a negative price pressure in the level of minus 1%. Year-to-date has been a bit lower, but we are seeing a price pressure, especially within the Wound Care area. We have talked earlier about France, and we are also seeing a negative price pressure in Greece due to the reimbursement reform that is going on in that market.

Carsten Lønborg Madsen - SEB, Research Division - Research Analyst

Yes, just for my understanding. You just said, it was lower than minus 1%, that doesn't mean it was -- lets say, gross spent you had thought or it's still was a little better when you have thought?

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

No. It is more or less in line with the expectations that we had when we started the year.

Oliver Metzger - Commerzbank AG, Research Division - Analyst

So lower is not 1.1%, it's more like 0.9%.

Anders Lonning-Skovgaard - Coloplast A/S - CFO and EVP

Okay, okay. Just we're in.

Operator

Our last question then comes from Yi-Dan Wang from Deutsche Bank.

Yi-Dan Wang - Deutsche Bank AG, Research Division - Research Analyst

I have several questions. So the first question is on R&D. I mean, you said that there is higher activity level, and I'm interested in whether we should expect to see a larger number of products coming out of that higher activity level, or is the activity level really relating to the quality of the product? I think historically, you said that the amount of R&D you were investing were really for delivering 2 to 3 major products to the business a year, so some comments on that will be great? And then secondly, interested in your capacity for Flex, relating to your comment that you said, it's doing better than you had expected. Just wondering whether there is a risk that we're running to the same sort of situation as your come back for the product after a while and you're short on capacity there? And yes, we'll stop with those, please.

Lars Rasmussen - Coloplast A/S - CEO and President

Yes, okay. On R&D, what -- we have a large number of products, but I think that what is adding more cost to it is what you have also seen on the Convex product. It's the first product in the market, which has a clinical documentation that it does reduce leakage. So it's a clinically relevant product. It's quite rare that we have that in our line of business. It's very hard to clinically prove that the product is doing one or the other. So



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therefore, it tends to be a little bit anecdotal and then it's normally very clear to the users of the products that this is a better product than they what they usually have. But clinically, we have had difficulty in putting products on the table where we can show clinically that this is reducing leaking or reducing costs or whatever. And the portfolio that we're bringing to market -- several of our products that we come with will be, what you can call, clinically differentiated. So that is new to the type of business that we are playing in. It has a cost, it also has some opportunities that we can talk at length about. And when it comes to the capacity for Flex, we have added the capacity that we have imagination to believe that we need plus some extra. So if we are also filling that capacity out, we will be in -- we'll have some problems to deliver costs but we will also have to adjust positively our guidance and everything else. So it's a lot of capacity that we've added online. So I don't think that in anyways that we will sell it out.

Yi-Dan Wang - Deutsche Bank AG, Research Division - Research Analyst

And follow-up on the R&D. Did you say that you do have a larger number of products coming out at the end of the process than you had anticipated?

Lars Rasmussen - Coloplast A/S - CEO and President

We have a little bit more products than -- if you take the average for the last 5 years, but that's not what is driving the cost really there. What is driving the cost is the clinically differentiation of the products, because we simply have to invest more in the clinical trials, and it takes a little bit longer to make those type of products.

Yi-Dan Wang - Deutsche Bank AG, Research Division - Research Analyst

Okay. So during your, I think, 2014 Capital Markets Day, you had indicated about your R&D programs are set to deliver products where hopefully, you could get higher reimbursements for. Have you managed to achieve that with these launches so far, or if not when could we expect to see that?

Lars Rasmussen - Coloplast A/S - CEO and President

That's the whole idea about the clinically differentiated products. And it is, you could say, it is actually building on that statement, because if you want want to have a higher reimbursement, you also need to be able to prove clinically that you are differentiated, that you are either saving money or that you certainly have to show that you save money. Either because people are using pure products or because they have less skin complications or because they're -- they get back to work early on or whatever it is that you are able to prove. And that's exactly the point of coming with clinically differentiated products that is that we are able to claim a high price for the product [income].

Yi-Dan Wang - Deutsche Bank AG, Research Division - Research Analyst

Have you manage to get the higher prices yet?

Lars Rasmussen - Coloplast A/S - CEO and President

No, we have not. We have -- well, we have -- yes, but not on a consistent basis. So the first product that we have launched where we have a clinical proof is the Convex product. That one we could not wait to put to the market, because we were not competitive we thought in the category. So we needed simply to have something to work with. But now we have new products across the board, we have great products across the board. So we can afford to put a product in the market now where we can also wait a little bit to get a better price. Because, of course, time to market will be a little bit longer when you go for clinically differentiated product, but you need better clinical documentation to obtain a higher price.



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Yi-Dan Wang - Deutsche Bank AG, Research Division - Research Analyst

And last question on Urology. How much of the growth that we're seeing in the last few quarters has come from ASTORA going out, meaning they went out about a year ago. So should we expect the growth rate to slow down as that affect annualizes?

Lars Rasmussen - Coloplast A/S - CEO and President

Yes. it's a -- of course, we get the higher growth from the fact that they are going out. So -- and that's, of course, for us to get a fair share of what is out there. So what we have done is that we have invested in surgery training last year. And that is what we're seeing, the effect for now. It's hard to say, what a normal momentum force is, but maybe more around 10% than what we are seeing currently. But when that is -- when that comes out, I don't have a clear guidance on that.

Lars Rasmussen - Coloplast A/S - CEO and President

All right. But then I just wanted to say to everybody who listened in, and thank you for your questions. And we'll see a lot of you in the coming periods. Thank you very much, and have a great evening.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation. Ladies and gentlemen, you may now disconnect.

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